

**Tax Returns With the Potential for Unreported  
Income Are Being Identified, but Some  
Challenges Still Exist With the Program**

**July 2003**

**Reference Number: 2003-30-146**

**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**

**Redaction Legend:**

2c = Law Enforcement Tolerance(s)



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

July 17, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION

*Gordon C. Milbourn III*

FROM: Gordon C. Milbourn III  
Assistant Inspector General for Audit (Small Business and  
Corporate Programs)

SUBJECT: Final Audit Report – Tax Returns With the Potential for  
Unreported Income Are Being Identified, but Some Challenges  
Still Exist With the Program (Audit # 200230048)

This report presents the results of our review of the Unreported Income Discriminant Index Function (UI DIF)<sup>1</sup> Program. The overall objective of this review was to determine if the Internal Revenue Service's (IRS) UI DIF Program effectively identifies tax returns with unreported income for examination.

In May 2001, the Small Business/Self-Employed (SB/SE) Division initiated an in-depth effort to reengineer its examination processes, products, and services. One of the recommendations of the reengineering team was the testing of the UI DIF. The UI DIF Program was developed to identify the potential for unreported income on tax returns of individuals.

In summary, the SB/SE Division has been actively involved in implementing, reviewing, and making changes to improve the quality and productivity of the UI DIF Program. The UI DIF Program has the potential to better identify tax returns with unreported income. However, we identified four areas where opportunities exist to further improve the Program.

The first area is that the UI DIF scoring technique may not reflect current income reporting practices of taxpayers. The technique was developed using information captured from examinations of Tax Year 1988 tax returns. The ways that small

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<sup>1</sup> The UI DIF is a technique that assigns numeric scores to tax returns of individuals to indicate the potential for unreported income.

business taxpayers report income have changed since 1988. The second area is that the criteria used for Fiscal Year 2003 to identify tax returns for potential UI DIF examinations did not place sufficient emphasis on individuals with businesses reporting high gross receipts. The third area is that examiners did not always perform adequate probes for unreported income when examining returns. Finally, the true impact of the Program will be difficult to capture because of the nature of UI DIF examinations. When tax returns report business losses, adjustments may not have a tax effect on the return being examined but could have important tax effect on other years.

We recommended that the SB/SE Division's Examination function management continue with their plans to update the UI DIF scoring technique, and consider modifying the identification criteria to place additional emphasis on tax returns of individuals with businesses that have total gross receipt of 2c-----Management should also continue with current efforts to improve the quality of examinations and consider using the Examination Information Report process<sup>2</sup> to better measure future compliance.

Management's Response: The Commissioner, SB/SE Division, agreed with our analysis of the UI DIF process and with the recommendations. The SB/SE Division plans to update the UI DIF formula based on the National Research Program<sup>3</sup> results, and issue written instructions and revise the new automatic case selection process to emphasize selection of tax returns of individuals with business gross receipts of 2c----- In-process reviews of UI DIF cases will continue. Also, training on techniques used on UI DIF cases will continue, and new training will be developed. In addition, the SB/SE Division plans to explore ways to capture adjustments and deductions as indicators of success in examining these returns. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Richard J. Dagliolo, Director (Submission Processing), at (631) 654-6028.

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<sup>2</sup> The Examination Information Report process is to be used when the results of a current examination affect unfiled tax returns, providing a means to follow up on future compliance relating to issues adjusted on the examined tax returns.

<sup>3</sup> The National Research Program is a process the IRS is currently using to measure taxpayer compliance levels through various means, including examinations of line items on tax returns.

**Tax Returns With the Potential for Unreported Income Are Being Identified,  
but Some Challenges Still Exist With the Program**

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**Table of Contents**

Background .....	Page 1
A Program to Identify Unreported Income Is Being Actively Implemented .....	Page 2
Some Opportunities Exist to Further Improve the Program .....	Page 4
<u>Recommendations 1 through 3:</u> .....	Page 9
<u>Recommendation 4:</u> .....	Page 10
Appendix I – Detailed Objective, Scope, and Methodology .....	Page 11
Appendix II – Major Contributors to This Report.....	Page 13
Appendix III – Report Distribution List .....	Page 14
Appendix IV – Definitions of Examination Activity Codes .....	Page 15
Appendix V – Management’s Response to the Draft Report .....	Page 16

## **Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program**

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### **Background**

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The Internal Revenue Service (IRS) estimates that the tax gap (i.e., the difference between the amount of tax owed and the amount of tax voluntarily paid) due to underreporting of income for individuals is \$119 billion annually. The largest single contributor to the tax gap is unreported income by sole proprietors, estimated at \$60 billion annually.

Having an effective compliance program to examine the accuracy of tax returns is one method that the IRS uses to help reduce that gap. In May 2001, the Small Business/Self-Employed (SB/SE) Division initiated an in-depth effort to reengineer its examination processes, products, and services. One of the recommendations of the reengineering team to address the tax gap was the testing of the Unreported Income Discriminant Index Function (UI DIF).

The UI DIF methodology was designed based on the same principles as the scoring technique for the Discriminant Index Function (DIF) process, which is the automated system historically used for identifying tax returns for examination. The DIF is a scoring technique designed to identify tax returns for examination that should have a high potential for tax change. The UI DIF score, on the other hand, indicates the potential that unreported income exists on a tax return, whether or not an adjustment would result in a tax change. In both methods, the higher the score, the greater the potential for examination.

The SB/SE Division tested the UI DIF scoring technique by having experienced examiners review tax returns scored by the technique and other data related to the tax return to determine if their assessment of examination potential agreed with the potential indicated by the numeric score. Testing is continuing by having field examiners perform examinations on the tax returns. About one-third of these pilot examinations were still in the examination process as of March 2003. The initial report summarizing the results of these pilot examinations once they are closed is scheduled for release in July 2003.

The SB/SE Division's Examination function included UI DIF examinations in their business plan for Fiscal Year (FY) 2003. The plan included completing examinations on 1,837 tax returns during FY 2003 and

## **Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program**

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tentatively increasing the number to 11,797 in FY 2004. This accounts for approximately 3 percent of the staff resources applied to examinations in FY 2003 and 7 percent in FY 2004. However, it appears that the actual closures for FY 2003 will exceed the plan based on the number of UI DIF identified examinations in process at the end of the second quarter of the fiscal year.

We initiated this review as part of our continuing involvement in reengineering efforts as requested by the Commissioner, SB/SE Division. We performed work in the SB/SE Division Headquarters in New Carrollton, Maryland; the SB/SE Division Research function's office in Denver, Colorado; the Raleigh, North Carolina IRS office; and the San Francisco, Modesto, and El Monte, California IRS offices. Our review was performed between September 2002 and April 2003 in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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### **A Program to Identify Unreported Income Is Being Actively Implemented**

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Our observations and testing conducted by the SB/SE Division's Research function show that the UI DIF scoring techniques do identify tax returns that appear to have the potential for unreported income. This was especially true for tax returns filed by individuals with business and farm entities reporting high gross receipts.

The scoring technique helps ensure that taxpayers are treated fairly and equitably. All U.S. Individual Income Tax Returns (Form 1040) within the categories of tax returns for which the UI DIF formula has been developed receive a score. The score is based on information included on various lines of the tax return.

The SB/SE Division is monitoring the UI DIF Program and identifying improvement opportunities. These opportunities include addressing improvements needed in the examination techniques and the overall quality of the examinations. Many of the specific monitoring action items for the UI DIF Program are currently scheduled to continue until late in FY 2004.

## **Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program**

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Some actions being taken to monitor and improve the UI DIF Program include:

- Performing case reviews of UI DIF examinations to determine if the scoring technique is effective, the examination techniques are appropriate, and the income probes are adequate.
- Conducting refresher training for managers and examiners on topics related to income probes.
- Assigning responsibility, through action items, to monitor and improve the UI DIF Program to various SB/SE Division executives.

The first report<sup>1</sup> from the review of open UI DIF examinations contained recommendations that are in various stages of implementation. The recommendations included:

- Issuing a memorandum and updating the Internal Revenue Manual (IRM) to reemphasize examination techniques for conducting income probes.
- Defining the need for managerial involvement with the examiner at critical points during the examination process.
- Continuing to give attention to leveling group size, providing managers with a span of control that allows them to become involved with the examiners' workloads.

The SB/SE Division has also released internal and external communications about the new Examination function priorities, including the UI DIF Program.

Continued efforts in these areas should help the SB/SE Division improve, as well as address some concerns relating to the UI DIF Program. SB/SE Division personnel working with the UI DIF Program share some of the same concerns that we mention in this report and are taking actions noted to address the concerns.

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<sup>1</sup> SB/SE Division, *UI-DIF In-Process Case Reviews* (dated November 15, 2002).

## **Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program**

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### **Some Opportunities Exist to Further Improve the Program**

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As mentioned above, efforts are currently underway to monitor and improve the UI DIF Program. This on-line monitoring of the UI DIF Program provides an excellent opportunity for the SB/SE Division to gather and analyze data for use in reducing risks identified with the Program. This will help the SB/SE Division's Examination function further its efforts in promoting voluntary compliance by providing additional information and program effectiveness data to use in making UI DIF Program decisions.

While the UI DIF Program has the potential to better identify tax returns with unreported income, we identified four areas where opportunities exist to further improve the Program. Some of the areas are already being addressed, at least in part, by actions of the SB/SE Division.

#### **Data used to develop the scoring technique are not current**

The UI DIF scoring technique may not be as effective as possible at identifying unreported income issues because current income reporting practices of taxpayers might not be reflected in the formulas. This could hinder the effectiveness of the Examination function in carrying out its responsibility of promoting voluntary compliance by selecting tax returns most in need of examination.

The scoring technique was developed based on data accumulated from the most recent Taxpayer Compliance Measurement Program (TCMP).<sup>2</sup> That data was captured from examinations of Tax Year 1988 tax returns. However, the ways that small business taxpayers report income have changed since 1988. For example, the number of partnership tax returns<sup>3</sup> filed has increased by 27 percent since that time, and small business corporate tax returns<sup>4</sup>

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<sup>2</sup> The TCMP was a process the IRS used to measure taxpayer compliance levels by analyzing data captured from examinations of items included on tax returns.

<sup>3</sup> A U.S. Return of Partnership Income (Form 1065) is filed for a trade or business and shows income, deductions, and partner's distributive share of taxable income.

<sup>4</sup> A U.S. Income Tax Return for an S Corporation (Form 1120S) is filed for a small business corporation and shows shareholder's income and losses.



## **Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program**

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filed have increased by 239 percent. Income and losses from these types of tax returns flow through to individuals and should be included on their Forms 1040.

The compliance data obtained from the TCMP are currently being updated through a revised process, called the National Research Program (NRP).<sup>5</sup> The SB/SE Division plans to revise the UI DIF formulas using the NRP data.

### **The criteria used for selecting UI DIF workload do not adequately emphasize high-income taxpayers**

Increasing the number of examinations of higher income taxpayers is a current goal for the SB/SE Division's Examination function. However, tax returns with activity codes<sup>6</sup> indicating gross receipts of 2c-----received essentially the same priority as returns with lower gross receipts. (Appendix IV describes the five activity codes included in the UI DIF process.)

To a large extent, this occurred because tax returns from many of the other various examination workload priorities were not available for examination during the first quarter of FY 2003. Therefore, the main source of returns for the field Examination function was those identified through the UI DIF Program, and there was not a sufficient workload available in the 2c-----category in every territory office.

One SB/SE Division executive indicated that the FY 2004 UI DIF workload priority would probably more heavily emphasize examinations of Activity Codes 2c- and 2c-- tax returns 2c-----  
2c-----

Initial UI DIF examination results show that the tax adjustment amounts are higher for Activity Code 2c- tax returns than other categories of tax returns. If the

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<sup>5</sup> The NRP is a process the IRS is currently using to measure taxpayer compliance levels through various means, including examinations of line items on tax returns.

<sup>6</sup> Activity codes are a series of categories used to designate the type of tax return filed and income amount reported on the tax return selected for examination.

## **Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program**

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productivity rates for the initial UI DIF examinations continue, the examination of these returns could help improve tax compliance and better reduce the tax gap. In addition, tax returns with larger gross receipt amounts might be considered more challenging and rewarding by examiners, which could help improve examination quality and productivity.

### **The search for unreported income was not adequate on some examinations**

The IRM requires that an examination of gross income on a business return include an analysis to determine if reported income is sufficient to support the taxpayer's financial activities. We reviewed 80 closed pilot UI DIF examinations and determined that the examiner's probe to identify unreported income was not adequate in 9 cases. The amount of income reported on the nine tax returns was not sufficient to pay business and living expenses, or the examiner did not address questionable income related issues. These cases were closed without an adjustment to income or expenses.

The SB/SE Division's review of open UI DIF examinations also identified issues relating to the quality of some UI DIF examinations. The report showed that the examiners were not always preparing a preliminary cash transaction account,<sup>7</sup> or reconciling the tax return to the taxpayer's books and records. These are two fundamental steps that should be completed when trying to identify unreported income during an examination.

Several factors could cause examiners to be reluctant to conduct income probes. First, the IRS Restructuring and Reform Act of 1998 (RRA 98)<sup>8</sup> added a requirement to determine that there is a reasonable indication that

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<sup>7</sup> A cash transaction account is a quick means to determine an indication of the potential for understated taxable income. The understatement may be a result of unreported gross receipts, overstated expenses, a simple math error, or from a combination of these items.

<sup>8</sup> IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

## **Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program**

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unreported income exists before examiners can use financial status or economic reality examination techniques. In addition, taxpayers can file claims that an employee is harassing them. An employee violation could lead to reprimand, disciplinary action, or removal.

Further evidence of this issue can be found in a recently issued General Accounting Office (GAO) report<sup>9</sup> containing results of its survey of compliance employees on the impact of some RRA 98 provisions. Some employees responded that the RRA 98 decreased the likelihood that they would assess a taxpayer's liability or contact third parties. Third-party contacts can be a source of information when searching for the existence of unreported income.

Another factor that could affect the depth of the income probe could be the long held Examination function expectation that examinations should result in an increase in tax. Many of the UI DIF identified tax returns have a business or farm that shows a loss. An examination could result in lowering the loss on the return but have no effect on the tax for that year. However, losses can be carried to other years and affect the tax on those years, so it is important that these losses be examined.

Changing attitudes and perspectives is difficult, especially in a large and wide-spread organization like the SB/SE Division's Examination function. However, the SB/SE Division has been working towards addressing these concerns by issuing memoranda about UI DIF and Examination function priority workload, updating and emphasizing instructions for using income probe techniques, and conducting training on issues relating to income probes. Continuing these efforts should help effect the change needed to improve the quality and depth of the income probes.

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<sup>9</sup> *IRS and TIGTA Should Evaluate Their Processing of Employee Misconduct under Section 1203* (GAO 03-394, dated February 2003).

## **Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program**

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### **The true impact of the UI DIF Program will be difficult to capture**

Some productivity measures for the Examination function are based on tax adjustment amounts and hours spent on examinations. These do not capture the true impact of the UI DIF Program because of the nature of UI DIF examinations. Various SB/SE Division managers working with the Program agree with this concern, but are frustrated with trying to develop measures that would be more effective. Data from the analysis of performance measures and indicators are needed when comparing various programs and making program-related decisions.

As noted in the preceding section, UI DIF examinations may not result in an increase in tax on the tax return being examined. In addition, these are more complex examinations that require substantial staff hours to perform, especially when in-depth income probes are necessary. Combining the impact of these issues might produce results that would not appear as effective as those of other programs based on the measures currently in place, such as dollars assessed per return. In addition, the primary benefit of improving future compliance is not captured in the short term.

One source of information about future compliance by taxpayers that were the subject of UI DIF examinations could be the Examination Information Report (Form 5346) process.<sup>10</sup> While we did not review the process, if used as provided for in the IRM it could be a source of information about future compliance on UI DIF Program examinations.

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<sup>10</sup> The Form 5346 process is to be used when results of a current examination affects unfiled tax returns, providing a means to follow up on future compliance relating to issues adjusted on the examined tax returns.

## Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program

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### Recommendations

The Chief, Centralized Workload Selection and Delivery, SB/SE Division, should:

1. Continue with current plans to update the UI DIF scoring technique after more current compliance information is obtained through the NRP.

Management's Response: SB/SE Division management plans to update the UI DIF formula based on NRP results.

2. Consider adjusting the UI DIF selection plan to concentrate on examinations of tax returns of individuals with total gross receipts 2c------(Activity Codes 2c- and 2c---.

Management's Response: SB/SE Division management will issue new written instructions to the field on assignment of strategic priority UI DIF cases. The SB/SE Division is revising the new automatic case selection process by activity code and UI DIF score. The FY 2004 Work Plan will emphasize examinations of Activity Code 2c- and 2c---UI DIF returns.

3. Continue with current efforts to conduct reviews of the UI DIF Program and provide training that reinforces appropriate use of income probe techniques.

Management's Response: SB/SE Division management stated it would develop and issue summary reports as part of its UI DIF Area reviews conducted during March, April, and May. In-process UI DIF case reviews were scheduled to be conducted throughout the nation starting in June 2003. Training will be scheduled for July 2003 to address delay tactics, procrastination, investigative techniques, and Income Probe methodology. In addition, Toolkit training for managers will continue to be rolled out, and Toolkit training for Examiners will be developed. The IRM section on Income Probes is also being revised to stress key required actions.

**Tax Returns With the Potential for Unreported Income Are Being Identified,  
but Some Challenges Still Exist With the Program**

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4. Consider capturing future compliance data from the Form 5346 process for UI DIF examinations and continue efforts to identify other means of capturing UI DIF Program effectiveness.

Management's Response: SB/SE Division management plans to explore ways to capture unreported income adjustments to taxable income reported, and net operating loss adjustments and deductions as indicators of success in examining these returns.

### **Detailed Objective, Scope, and Methodology**

The overall objective of this review was to determine if the Internal Revenue Service's (IRS) Unreported Income Discriminant Index Function (UI DIF)<sup>1</sup> Program effectively identifies tax returns with unreported income for examination. To accomplish our objective, we:

- I. Determined if the UI DIF scoring technique provides for fair and equitable treatment of taxpayers.
  - A. Obtained and analyzed the programming routine for the UI DIF score.
  - B. Discussed the theory behind the Program with programmers that developed the concept and effect that the National Research Program (NRP)<sup>2</sup> results would have on the formulas.
- II. Determined if UI DIF testing accurately portrayed examination techniques and the effect when the concept was implemented.
  - A. Discussed UI DIF testing and pilot project management with Small Business/Self-Employed (SB/SE) Division personnel.
  - B. Reviewed the test process used during the classification testing of UI DIF returns.
  - C. Obtained and analyzed reports of UI DIF studies.
  - D. Discussed the current status of UI DIF testing and the potential recommendations resulting from the testing.
  - E. Reviewed the effect of the UI DIF Program in the Examination Plan.
- III. Determined how the Examination function assessed the pilot results.
  - A. Reviewed the database used to capture pilot examination results and discussed how the results would be analyzed.
  - B. Reviewed the results of the UI DIF formula tests.

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<sup>1</sup> The UI DIF is a technique that assigns numeric scores to tax returns of individuals to indicate the potential for unreported income.

<sup>2</sup> The NRP is a process the IRS is currently using to measure taxpayer compliance levels through various means, including examinations of line items on tax returns.

## **Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program**

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- C. Reviewed a judgmental sample of 80 pilot examinations closed as of December 2002 to assess the UI DIF examination results and the potential for unreported income on the tax returns. The sample was taken from closed cases for which the SB/SE Division Research function's office in Denver, Colorado, had received copies of examination workpapers. The sample included cases from all activity codes (see Appendix IV for definitions of examination activity codes) and types of closing codes. The judgmental sample method was used because this was an ongoing pilot and only a small portion of the pilot cases were closed.
  - D. Analyzed the results of the pilot examinations by examination issue and activity code of the tax return.
  - E. Discussed the effect of UI DIF examinations with three Revenue Agents<sup>3</sup> and the group manager in each of four examination groups (three area offices), with Planning and Special Programs (PSP) personnel located in one area office, and with the West Territory PSP Manager.
- IV. Determined the effect on the public of conducting UI DIF examinations and how the IRS addressed the issue.
- A. Reviewed publicity released by the IRS about UI DIF examinations.
  - B. Discussed how SB/SE Division addressed the potential for dealing with uncooperative taxpayers during UI DIF examinations.
  - C. Reviewed the length of time being spent on UI DIF examinations compared to Discriminant Index Function (DIF)<sup>4</sup> examinations.
  - D. Discussed plans for including the UI DIF score in routine processing and the effect of including both the DIF and UI DIF scores on tax returns of individuals.

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<sup>3</sup> A Revenue Agent is an Examination function employee that conducts field examinations of tax returns.

<sup>4</sup> The DIF is an automated process used by the Examination function that scores tax returns to indicate the potential for examination.



**Tax Returns With the Potential for Unreported Income Are Being Identified,  
but Some Challenges Still Exist With the Program**

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**Appendix II**

**Major Contributors to This Report**

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Parker F. Pearson, Director  
Amy L. Coleman, Audit Manager  
Philip A. Smith, Senior Auditor  
Joseph P. Snyder, Senior Auditor

**Tax Returns With the Potential for Unreported Income Are Being Identified,  
but Some Challenges Still Exist With the Program**

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**Appendix III**

**Report Distribution List**

Commissioner N:C  
Deputy Commissioner for Services and Enforcement N:SE  
Acting Deputy Commissioner, Small Business/Self-Employed Division S  
Director, Compliance, Small Business/Self-Employed Division S:C  
Director, Compliance Policy, Small Business/Self-Employed Division S:C:CP  
Director, Reporting Compliance, Small Business/Self-Employed Division S:C:CP:RC  
Chief, Centralized Workload Selection and Delivery, Small Business/Self-Employed  
Division S:C:CP:CW  
Director, Office of Research, Analysis and Statistics N:ADC:R  
Director, Office of Research N:ADC:R:R  
Director, Strategy, Research and Performance Management, Small Business/Self-  
Employed Division S:SF:S:R:R  
Director, Research, SRPM, Small Business/Self-Employed Division S:SF:S:R:R  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O  
Office of Management Controls N:CFO:AR:M  
Audit Liaison: Commissioner, Small Business/Self-Employed Division S:C:CP:I

**Tax Returns With the Potential for Unreported Income Are Being Identified,  
but Some Challenges Still Exist With the Program**

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**Appendix IV**

**Definitions of Examination Activity Codes**

<b>Activity Code</b>	<b>Activity Code Definition</b>
<del>2C</del> 2	-----
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~~2C~~-----  
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# Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program

## Appendix V

### Management's Response to the Draft Report



COMMISSIONER  
SMALL BUSINESS/Self-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

JUL 9 2003

#### MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: Dale F. Hart *Dale Hart by MS 11.2*  
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Tax Returns With the Potential for  
Unreported Income Are Being Identified, but Some Challenges  
Still Exist With the Program (Audit # 200230048)

I have reviewed your draft report and agree with your recommendations. I appreciate your acknowledgement of the actions we have taken to improve the quality and productivity of the Unreported Income Discriminant Index Function (UI DIF) Program. We developed the UI DIF Program in May 2001 to identify the potential for unreported income on individual tax returns.

We are improving the program by conducting "in process" UI DIF case reviews. These reviews help us identify trends to ensure the quality of case selection and examination. Based on these trends, we issued instructions to emphasize examinations of Activity Code **2c** and **2c** UI DIF returns over other Activity Code categories. In addition, we scheduled Interactive Video Teleconferences (IVTs) to address Taxpayer/Representative (TP/Rep) delay tactics, procrastination, investigative techniques, perfection of the Bank Deposit Analysis, and Mark-up Methodology. Both the Bank Deposit Analysis and Mark-up Methodology are indirect methods our examiners use to detect and quantify unreported income.

We are exploring ways to capture unreported income adjustments to reported taxable income. We will also look at ways to capture net operating loss adjustments and net operating loss deductions as additional indicators of success in auditing UI DIF returns.

Our comments on your recommendations follow:

#### **RECOMMENDATION 1**

Continue with current plans to update the UI DIF scoring technique after more current compliance information is obtained through the National Research Program (NRP).

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## **Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program**

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2

### **CORRECTIVE ACTION**

Update UI DIF formula based on the National Research Program results.

### **IMPLEMENTATION DATE**

February 15, 2007

### **RESPONSIBLE OFFICIAL(S)**

Director, Centralized Workload Selection and Delivery, Small Business/Self Employed Division

### **CORRECTIVE ACTION MONITORING PLAN**

The Program Manager, Examination Return Selection will advise the Director, Centralized Workload Selection and Delivery of corrective action delays.

### **RECOMMENDATION 2**

Consider adjusting the UI DIF selection plan to concentrate on examinations of tax returns of individuals with total gross receipts of \$ [REDACTED], Activity Codes [REDACTED] and [REDACTED]

### **CORRECTIVE ACTION**

The Acting Director, Compliance will issue new written instructions to the field on assignment of strategic priority UI DIF cases to formalize verbal instructions. The office of Centralized Workload Selection and Delivery (CWSD) is revising the new automatic case selection process by activity code and UI DIF score. Until then, CWSD was notified to send Activity Code [REDACTED] and [REDACTED] UI DIF returns to fill return orders, where available.

The Fiscal Year 2004 Work Plan will emphasize examinations of Activity Code [REDACTED] and [REDACTED] UI DIF returns.

### **IMPLEMENTATION DATE**

October 15, 2003

### **RESPONSIBLE OFFICIAL(S)**

Director, Centralized Workload Selection and Delivery, Small Business/Self Employed Division

## **Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program**

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3

### **CORRECTIVE ACTION MONITORING PLAN**

The Program Manager, Workload Planning and Analysis will advise the Director, Centralized Workload Selection and Delivery of corrective action delays.

### **RECOMMENDATION 3**

Continue with current efforts to conduct reviews of the UI DiF Program and provide training that reinforces appropriate use of income probe techniques.

### **CORRECTIVE ACTION**

The office of Reporting Compliance, Examination Specialization and Technical Guidance will develop and issue summary reports as part of its UI DiF Area reviews conducted during March, April, and May. Technical Services will conduct "in process" UI DiF case reviews throughout the nation starting June 2003. We will schedule IVTs in July 2003 to address TP/Rep delay tactics, procrastination, investigative techniques, perfection of the Bank Deposit Analysis, and Mark-up Methodology. Toolkits, which provide guidance to facilitate communication and coordination for a specific program area, have been developed for UI DiF cases. Toolkit training on the use of income probes and indirect methods for Group Managers will continue to be rolled out. Toolkit training for Examiners will be developed. We are revising the Internal Revenue Manual (IRM) section on Income Probes to stress key required actions.

### **IMPLEMENTATION DATE**

January 15, 2004

### **RESPONSIBLE OFFICIAL(S)**

Director, Reporting Compliance, Small Business/Self Employment Division

### **CORRECTIVE ACTION MONITORING PLAN**

The Program Manager, Examination Specialization & Technical Guidance will advise the Director, Reporting Compliance of corrective action delays.

### **RECOMMENDATION 4**

Consider capturing future compliance data from the Form 5346 (Examination Information Report) process for UI DiF examinations and continue efforts to identify other means of capturing UI DiF Program effectiveness.

### **CORRECTIVE ACTION**

We considered using the Form 5346; however, it does not capture compliance data that would significantly reflect the effectiveness of the UI DiF Program. As an alternative, we are exploring ways to capture unreported income adjustments to taxable income reported, since that is the program's intent. We are also exploring ways to capture net operating loss adjustments and net operating loss deductions as additional indicators of

## **Tax Returns With the Potential for Unreported Income Are Being Identified, but Some Challenges Still Exist With the Program**

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success in auditing these returns. We are also monitoring the impact of our Fraud Program.

### **IMPLEMENTATION DATE**

October 15, 2004

### **RESPONSIBLE OFFICIAL(S)**

Director, Reporting Compliance, Small Business/Self Employed Division

### **CORRECTIVE ACTION MONITORING PLAN**

The Program Manager, Examination Return Selection will advise the Director, Centralized Workload Selection and Delivery of corrective action delays.

If you have any questions, please call me at (202) 622-0600 or Joseph R. Brimacombe, Deputy Director, Compliance Policy, Small Business/Self-Employed Division at (202) 283-2200.